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No. 92-1941

In The

Supreme Court of the United States

October Term, 1993

UNITED STATES OF AMERICA,

Petitioner,

v.

JERRY W. CARLTON, EXECUTOR OF THE WILL OF WILLAMETTA K. DAY,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

BRIEF FOR RESPONDENT

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QUESTION PRESENTED

Can the government enact a new estate tax deduction to induce executors to sell estate assets at a discount to an employee stock ownership plan and, after a taxpayer has done so, deprive the taxpayer of the benefit of the deduction by imposing unforeseeable conditions retroactively?

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STATEMENT OF THE CASE

In 1984, the Senate proposed an estate tax deduction for one-half of the proceeds of an executor's sale of a company's stock to its employee stock ownership plan ("ESOP") completed before the deadline for filing the federal estate tax return (including any extension). (Br. in Opp. App. 49a.)[1] Although not enacted in 1984, Congress

[1] Following the convention of the Brief on the Merits of the United States, respondent cites the Stipulation and Order of Uncontroverted Facts and Narrowing Potential Issues in Controversy by reference to Appendix E of respondent's Brief in

enacted a similar provision that became effective October 22, 1986. Tax Reform Act of 1986, Pub. L. No. 99-514 (the "TRA"), § 1172, 100 Stat. 2085, 2513-15 (codified at 26 U.S.C. § 2057) (amended 1987; repealed 1989).[2]

Between the time it passed the TRA and its adjournment, the 99th Congress considered a large number of potential "corrections" to the TRA and made several changes to it. No bill or resolution was introduced, however, that would have added any additional condition to the availability of the new estate tax deduction to those contained in the statute itself. (Br. in Opp. App. 48a-49a.)

Willametta K. Day ("Mrs. Day") had died on September 29, 1985. Taking into account a six-month extension, the federal estate tax return for her estate was due on December 29, 1986. As executor of Mrs. Day's will, Jerry W. Carlton ("the executor") reviewed the provisions of the TRA, its amendments, and the possible amendments to it proposed before Congress adjourned and determined that it was in the estate's financial interest to avail itself of the new estate tax deduction. He then purchased 1,500,000 shares of MCI Communications Corporation ("MCI") stock on December 10, 1986 for an average price of $7.47 per share. Although he had determined that its ESOP might be interested in acquiring some MCI stock, the executor had no advance agreement to sell the stock

Opposition. A copy of the original appears as item 14 of the clerk's record from the District Court and under tab 3 of the Excerpts of Record in the Court of Appeals.

[2] Unless otherwise specified, section references are to the Internal Revenue Code of 1986 (26 U.S.C.) (Supp. IV 1986). The relevant portion of the 1986 legislation is quoted at note 1 of respondent's Brief in Opposition.

to the ESOP and, thus, bore the market risk of holding the stock for sale to the ESOP or on the open market. (Br. in Opp. App. 50a.)

On December 12, 1986, the trading price for MCI stock ranged from $7.125 to $7.50; the executor entered into an agreement to sell the stock to the ESOP for $7.05 per share. In accordance with Section 2057, the executor obtained MCI's agreement to the application of Section 4979A (amended 1989) to MCI (as required by Section 2057(d) (amended 1987; repealed 1989)) and obtained an opinion from MCI's general counsel that its ESOP was a plan described in Section 4975(e)(7) (amended 1990) (as required by Section 2057(b)(1) (amended 1987; repealed 1989)). On December 17, 1986, the sale was consummated. (Br. in Opp. App. 50a-51a.)

The government has conceded that the executor would *not* have purchased the stock at its then-prevailing price of $7.47 per share and sold it to the ESOP at a discounted $7.05 per-share price (and incurred incidental transaction costs) but for the Section 2057 deduction and that the ESOP would *not* have been able to purchase the stock at the discounted price if the executor had not expected to receive that deduction. (Br. in Opp. App. 51a.)

On December 29, 1986, the executor timely filed Mrs. Day's federal estate tax return, claiming a deduction for 50 percent of the proceeds of sale of the MCI stock and paying $18,752,250 in estate tax. (Br. in Opp. App. 51a.)

On January 5, 1987, the Internal Revenue Service (the "Service") announced that "[p]ending the enactment of *clarifying* legislation," it would *not* allow a Section 2057

deduction: (1) unless a decedent "directly owned" the securities before death and (2) unless the securities were allocated or held for future allocation *by the plan* in particular ways.[3] I.R.S. Notice 87-13, 1987-1 C.B. 432, 442 (emphasis added). The government has conceded that neither requirement was contained in the TRA and that neither was identified in the hundreds of technical and clerical amendments proposed before Congress adjourned. (Br. in Opp. App. 52a.)

On December 22, 1987, Congress enacted legislation imposing these two additional requirements retroactively to October 22, 1986 – as well as making a number of other changes effective for sales made after February 26, 1987, the date of introduction of the 1987 legislation. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, §§ 10411, 10412, 101 Stat. 1330, 1330-432 to 1330-436 (codified at 26 U.S.C. § 2057 (Supp. V 1987) (repealed 1989)).

After the Service audited Mrs. Day's federal estate tax return, it disallowed the claimed ESOP proceeds deduction[4] and denied the executor's claim for refund after the executor paid the deficiency assessed. (Br. in Opp. App. 53a-54a.) The executor then instituted this refund action. The District Court held for petitioner, and

[3] In general, the 1987 plan allocation rules (a) require that the ESOP immediately allocate the securities to participants' accounts or hold them for future allocation in accordance with rules that apply in other contexts and (b) preclude the ESOP from substituting the securities for other employer stock already held by the ESOP.

[4] The deficiency attributable to the ESOP proceeds deduction was $2,501,161. (Br. in Opp. App. 54a.)

the Ninth Circuit reversed and remanded with instructions to enter judgment for the executor (Norris, J., dissenting). *Carlton v. United States*, 972 F.2d 1051 (9th Cir. 1992). The Ninth Circuit denied a petition for rehearing and rejected a suggestion for rehearing en banc.

SUMMARY OF ARGUMENT

The Due Process Clause limits the Congress's Taxing Power by prohibiting the retroactive application of unduly harsh and oppressive changes. "In each case, it is necessary to consider the nature of the tax and the circumstances in which it is laid before it can be said [whether] its retroactive application is so harsh and oppressive as to transgress the constitutional limitation." *Welch v. Henry*, 305 U.S. 134, 147 (1938). *Accord United States v. Hemme*, 476 U.S. 558, 568-69 (1986).

Among numerous provisions included in the TRA to promote stock ownership through ESOPs, Congress enacted a new federal estate tax deduction to induce executors to sell stock to ESOPs at a discount below fair market value. Relying on the inducement of this deduction, Mrs. Day's executor purchased MCI stock in the open market and resold it to the MCI ESOP at a discount below fair market value. The transaction complied with all then-existing requirements of the statute. The executor filed the estate tax return, and paid the tax due. The government now seeks to deny the executor the deduction and impose an involuntary gift to the ESOP participants by adding, retroactively, two unforeseeable conditions on the deduction.

Retroactive application of the two unforeseeable conditions in this instance violates the Due Process limitation. It is singularly harsh and oppressive for Congress to use the inducement of a tax benefit to encourage private support of the public goal of promoting employee stock ownership and, subsequently, to deny a taxpayer the very benefit that induced the purchase and sale.

None of the cases cited by the Solicitor General involves government inducement of a transaction to accomplish a public goal with private funds. Moreover, most involve taxpayer action after a legislative change had been proposed. Finally, the justifications for the retroactive amendments postulated by the government do not support retroactive application in this instance.

ARGUMENT

I. DUE PROCESS LIMITS HARSH AND OPPRESSIVE RETROACTIVE TAXATION.

Due Process requires that the retroactive effect of tax legislation be supported by a legitimate legislative purpose furthered by rational means. *Pension Benefit Guar. Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 729 (1984). What satisfies this purpose and means test in the context of prospective legislation may not suffice for retroactive legislation. *Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 16-17 (1976).[5] Moreover, a tax statute may not be applied

[5] "[R]etroactive legislation does have to meet a burden not faced by legislation that has only future effects." *Pension Benefit Guar. Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 730 (1984). "Retroactive legislation presents problems of unfairness that are more serious than those posed by prospective legislation, because it can deprive citizens of legitimate expectations and upset settled transactions." *General Motors Corp. v. Romein*, 112 S. Ct. 1105, 1112 (1992).

retroactively if an unduly "harsh and oppressive" result arises from the "nature of the tax and the circumstances in which it is laid." *United States v. Hemme*, 476 U.S. 558, 568-69 (1986); *Welch v. Henry*, 305 U.S. 134, 147 (1938). By definition, retroactive legislation that is unduly harsh and oppressive in its application does not further its purpose by a rational means. Indeed, the "harsh and oppressive" standard is functionally equivalent to the "arbitrary and irrational" inquiry used to test the due process sufficiency of retroactive civil litigation in contexts outside the tax field. *See Gray*, 467 U.S. at 733.[6]

The "harsh and oppressive" test requires consideration of both the object of legislation and its effect upon the taxpayer. The inquiry is necessarily fact-based, looking to the nature, purpose and background of the legislation on the one hand, and to its effect on the taxpayer on the other. In considering the nature of the tax and the circumstances in which it is laid, the Court has been concerned with (1) whether taxation was reasonably foreseeable at the time of a transaction, (2) whether, if foreseen, the taxpayer might have avoided the tax, and (3) whether the taxpayer was injured by retroactive application of the change. In the context of reviewing retroactive changes of state law, the Court also has

[6] The Court sometimes has described the retroactive application of a revenue measure that transgressed the Due Process limit as "arbitrary and capricious." *See, e.g., Nichols v. Coolidge*, 274 U.S. 531, 542 (1927).

been concerned with protecting a citizen who has been induced by the government to devote private resources to pursue a public goal; the same concern is relevant in considering the circumstances of retroactive federal taxation.

The parameters of the "harsh and oppressive" test initially were developed from a series of earlier estate and gift tax cases in which the Due Process limit had been transgressed.[7] Writing in *Welch*, Justice Stone summarized the rationale of these cases as follows:

[7] In *Nichols v. Coolidge*, 274 U.S. 531 (1927), the Court had prohibited the application of a provision of the 1919 estate tax statute taxing a transfer taking effect at death to two groups of assets in which Mrs. Coolidge had retained an interest for her life but in which she had transferred the successive interest before enactment. *Accord Helvering v. Helmholz*, 296 U.S. 93, 96-97 (1935) (alternative holding in which all justices concurred); *White v. Poor*, 296 U.S. 98, 102 (1935) (alternative holding). Mrs. Coolidge's transfers came back before the Court in *Coolidge v. Long*, 282 U.S. 582 (1931). Retroactive application of Massachusetts' inheritance tax also was a Due Process and Contract Clause violation. 282 U.S. at 595-96, 605-606.

In *Blodgett v. Holden*, 275 U.S. 142 (1927), the Court had found a Due Process constraint in the retroactive application of the first federal gift tax. In that case, four justices interpreted the statute to avoid the Constitutional question, while four others concluded that retroactive application was arbitrary and violated the Due Process Clause. "As to the gifts which Blodgett made during January, 1924 [before introduction on February 25 or enactment on June 2], we think the challenged enactment is arbitrary and for that reason invalid. It seems wholly unreasonable that one who, in entire good faith and without the slightest premonition of such consequence, made absolute disposition of his property by gifts should thereafter be required to pay a charge for so doing." 275 U.S. at 147 (McReynolds, J.). *See Untermyer v. Anderson*, 276 U.S. 440 (1928) (in which the majority followed Justice McReynolds' opinion in *Blodgett*).

> In the cases in which this Court has held invalid the taxation of gifts made and completely vested before the enactment of the taxing statute, decision was rested on the ground that the nature or amount of the tax could not reasonably have been anticipated by the taxpayer at the time of the particular voluntary act which the statute later made the taxable event. . . . Since, in each of these cases, the donor might freely have chosen to give or not to give, the taxation, after the choice was made, of a gift which he might well have refrained from making had he anticipated the tax, was thought to be so arbitrary and oppressive as to be a denial of due process.

305 U.S. at 147 (citations omitted).[8]

The Court identified another circumstance relevant in determining whether retroactive taxation was unduly "harsh and oppressive" in *Hemme*: "One of the relevant circumstances is whether . . . a statute gives a different and more oppressive legal effect to conduct undertaken before enactment of the statute." 476 U.S. at 569.[9]

[8] In an article cited by the Solicitor General, Professor Hochman concluded: "The primary consideration which appears from an analysis of the cases involving retroactive taxation is the ability of the taxpayer, at the time of the transaction in dispute, reasonably to have foreseen that a tax would be imposed, and the likelihood that, having been able to foresee it, he would have altered his conduct to avoid the tax." Charles B. Hochman, *The Supreme Court and the Constitutionality of Retroactive Legislation*, 73 Harv. L. Rev. 692, 706 (1960) (footnote omitted).

[9] Justice Thurgood Marshall described the foreseeability consideration as whether the taxpayer had "notice" of the

An additional concern, and one that sets this case apart, is whether the retroactive change deprives a citizen of a benefit that the government used to induce that citizen to behave in a particular way and in which he or she would not have behaved but for the benefit. Such a change is especially harsh and oppressive. The historic roots of this consideration lie in early cases reviewing retroactive state legislation.[10]

For example, in *New Jersey v. Wilson*, 11 U.S. (7 Cranch) 164 (1812), the Marshall Court rejected New Jersey's attempt to rescind (prospectively) a property tax exemption for formerly Indian-owned land that had been enacted to induce the Indians to release their claim to other New Jersey land. (Presumably, the purchasers of the land also took the tax exemption into consideration in determining the price).[11]

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change in the law. *Hemme*, 476 U.S. at 569 (1986); *cf. Gray*, 467 U.S. at 733; *United States v. Darusmont*, 449 U.S. 292, 299 (1981) (per curiam).

[10] Professor Tribe refers to "a simple constitutional principle," that when it induces reliance, *"government must keep its word."* Laurence H. Tribe, *American Constitutional Law* 619 (2d ed. 1988) (discussing limitations on state government action) (footnote omitted) (emphasis added).

[11] *Cf. Fletcher v. Peck*, 10 U.S. (6 Cranch) 87 (1810) (attempted rescission of scandal-tainted land grants where Fletcher purchased Georgia land relying on title traceable to 1795 grants); *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518 (1819) (after donors had financed the college in reliance on the terms of its perpetual charter from the Crown, New Hampshire's "hostile takeover" by changing the charter and "packing" the board of trustees was unconstitutional).

Early Marshall Court decisions were followed throughout the 19th Century in both state-granted monopoly[12] and tax exemption cases. In *Wilmington Railroad v. Reid*, 80 U.S. (13 Wall.) 264 (1872), North Carolina's withdrawal of a tax benefit was overturned:

> The General Assembly of North Carolina told the Wilmington and Weldon Railroad Company, *in language which no one can misunderstand*, that if they would complete the work of internal improvement for which they were incorporated, their property and the shares of their stockholders should be forever exempt from taxation.

80 U.S. at 267 (emphasis added). *Accord Humphrey v. Pegues*, 83 U.S. (16 Wall.) 244 (1873); *Pacific R.R. v. Maguire*, 87 U.S. (20 Wall.) 36 (1874).

By the early 20th Century, the basis for reviewing retroactive state legislation had shifted largely from the Contract Clause to the Due Process Clause of the Fourteenth Amendment.[13] In *Forbes Pioneer Boat Line v. Board of Commissioners*, 258 U.S. 338 (1922), Justice Holmes stated:

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[12] *E.g., The Binghamton Bridge*, 70 U.S. (3 Wall.) 51 (1866) (New York could not authorize a new bridge to compete with one built earlier in the century under a charter granting an exclusive franchise).

[13] Alexander M. Bickel & Benno C. Schmidt, Jr., *The Judiciary and Responsible Government 1910-21* 300 (The Oliver Wendall Holmes Devise History of the Supreme Court of the United States Vol. IX, 1984).

> Stripped of conciliatory phrases the question is whether a state legislature can take away from a private party a right to recover money [a tax refund] that is due when the act is passed.

258 U.S. at 339. That case arose out of the 1913-1917 unauthorized collection of tolls for passing through a lock installed in an Everglades drainage canal in 1913. Summarizing the case, Justice Holmes said:

> Defendant [the toll collector] owed the plaintiff [a canal user] a definite sum of money that it had extorted from the plaintiff without right. . . . To say that the Legislature simply was establishing the situation as both parties knew from the beginning it ought to be [by purportedly retroactive legislation authorizing toll collection] would be putting something of a gloss upon the facts. We must assume that the *plaintiff went through the canal relying upon its legal rights and it is not to be deprived of them because the Legislature forgot*.

258 U.S. at 340 (emphasis added).[14]

Application of the *Welch* "harsh and oppressive" limit on retroactive taxation in the circumstances of this case prohibits restriction of the Section 2057 estate tax deduction by the decedent ownership and plan allocation requirements because: (1) the executor had no notice, actual or constructive, that Congress would renege on the deduction; (2) the executor acted in complete reliance on the availability of the deduction and would not otherwise

[14] *See generally Ettor v. City of Tacoma*, 228 U.S. 148 (1913) (Washington legislature's retroactive attempt to deprive a landowner of consequential damages).

have engaged in the transaction; (3) the executor was injured by making the sale below market; and (4) unlike any other prior challenge to retroactive federal tax legislation, the statute *specifically induced* the executor to act to his detriment in furtherance of employee stock ownership in language that no one can misunderstand.[15] He cannot be deprived of the benefit of the deduction, even if this Court were to conclude that the Legislature forgot to include the two subsequently imposed conditions.

[15] The Solicitor General attempts to confine the holding of the estate and gift tax cases that have invalidated retroactive taxes on Due Process grounds to instances of "wholly new taxes." (Br. for U.S. 21 n.17.) As the Court of Appeals recognized, that view is overly narrow; the Court's detailed review of the circumstances in *Hemme* and *United States v. Darusmont*, 449 U.S. 292 (1981) (per curiam), would have been unnecessary if there were a *per se* rule that the Due Process limit is relevant to only a "wholly new" tax. *Carlton*, 972 U.S. at 1056. Justice Stone's and Professor Hochman's synopses illustrate that retroactive application of the new taxes in the old estate and gift tax cases was unduly "harsh and oppressive" because it was unforeseeable and prevented the taxpayers from planning their estates to reduce or avoid the taxes. See *supra* note 8 and accompanying text. The factors of foreseeability and reliance are even more compelling here. There could hardly be a circumstance less foreseeable to a taxpayer than for his government to induce him to devote his resources to support a public goal and, then, after he has done so, to rescind the deduction that provided the inducement. Even assuming foreseeability and reliance were not, by themselves, sufficient reasons to invalidate the retroactive application of a tax, there can be little question that the line defining "harsh and oppressive" application is crossed where the taxpayer's conduct has been induced as well.

II. IN THE CIRCUMSTANCES OF THIS CASE, THE DUE PROCESS LIMITATION WAS EXCEEDED BY THE RETROACTIVE RESTRICTIONS ON THE SECTION 2057 DEDUCTION.

As discussed in detail below, the retroactive changes to Section 2057 were not foreseeable by the executor in December 1986. There can be no dispute about the other three considerations identified in Section I for determining whether retroactive taxation is unduly harsh and oppressive. Not only *might* the executor have changed his conduct if he had foreseen the change, the government has stipulated that the executor *would* have changed his behavior. (Br. in Opp. App. 51a.) Similarly, the government has stipulated that the executor was injured by the transaction. (*Id.* at 50a-51a.) Finally, the government has stipulated that the executor's behavior was induced by the benefit of the Section 2057 deduction: (1) He would not have sold the MCI stock to the ESOP at a below-market price (and incurred incidental transaction costs) if he had not expected the Section 2057 deduction (Br. in Opp. App. 51a), and (2) he was entitled to the deduction as the statute then existed (*id.* at 54a). Indeed, there was no conceivable reason for *any* executor to sell *any* stock to an ESOP at a below-market price other than to obtain the expected tax benefit.

A. In the Context of the Extraordinary Tax Benefits that Congress Has Used to Promote ESOPs, Section 2057 Was Neither Unusual Nor Surprising.

The new 1986 estate tax deduction was a part of the nation's long-standing policy of providing extraordinary

encouragement for the growth of ESOPs through tax benefits.[16] As summarized by the General Accounting Office in late 1986:

> The major purposes of [ESOPs] are to broaden the ownership of stock, to provide a mechanism for financing capital growth and the transfer of stock ownership to employees, and to promote improvements in productivity and profitability in sponsoring firms. These goals are based on the belief that the concentration of stock ownership, the dependence of firms on internal sources of funds for corporate finance, and the slow growth of productivity in the U.S. are serious and related problems that can be addressed by making employees owners of stock in the firms that employ them.

Employee Stock Ownership Plans: Benefits and Costs of ESOP Tax Incentives for Broadening Stock Ownership (GAO/PEMD 87-88) 4 (1986). In the context of the wide variety and scope of ESOP deductions, credits and exclusions that Congress had

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[16] *See generally* Staff of Joint Committee on Taxation, 99th Cong., 1st Sess., *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs)* 2-14 (Comm. Print 42-85 1985) (the "1985 Joint Committee Study"); *see also* 132 Cong. Rec. 14507, 14512-13 (1986) (statement of Sen. Long).

The most basic tax benefit for ESOPs (and one applicable to other retirement plans) is tax deferral. The tax law provides an incentive for an employer to fund a stock bonus plan that makes employees part owners of the business by allowing the employer an immediate corporate income tax deduction while deferring any income tax consequence to each employee until the plan makes a distribution to the employee. 26 U.S.C. §§ 402(a), 404(a) (Supp. IV 1992). In effect, the government makes an interest-free loan equal to the income tax otherwise payable either by the employer or the employee that is repaid when the ESOP makes distributions to its employee-participants.

employed over the years, the executor had no reason to anticipate the imposition of a decedent ownership or plan allocation condition to restrict the scope of Section 2057.

Virtually every major tax bill from 1974 until Senator Russell B. Long's retirement at the end of 1986 contained ESOP tax subsidies. These began with the Employee Retirement Income Security Act of 1974 ("ERISA"), which included a substantial number of provisions unique to ESOPs,[17]

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[17] Under ERISA, ESOPs are exempt from the general requirement that no more than 10% of a retirement plan's assets can be invested in the stock of the employer, 29 U.S.C. §§ 1104(a)(2), 1107(b)(1), 1107(d)(3) (Supp. IV 1986), and an employer's sale of stock to its ESOP is exempt from the generally applicable prohibited transaction rules, 29 U.S.C. § 1108(e) (Supp. IV 1986); Section 4975(d)(13) (amended 1990).

An employer also is allowed to make loans and guarantee third-party loans to its ESOP that are used to purchase employer stock – which dramatically increases the amount of stock an ESOP can purchase. 29 U.S.C. § 1108(b)(3) (1982); 26 U.S.C. § 4975(d)(3) (1982). These provisions for "leveraged" ESOP stock purchases make ESOP funding a major tool of corporate finance. Repayment of ESOP loans is financed through fully deductible employer contributions – effectively allowing the employer to finance both principal and interest of the loans with pre-tax corporate income. Section 404(a)(9). As a corporate finance device, the potential tax benefit is almost unlimited; the deduction for repayment of principal is limited only by 25% of the participants' *entire* payroll (principal payments allocable to any single plan participant may be as high as $30,000), and the deduction for payment of interest is unlimited. Sections 404(a)(9)(A)-(B), 415(c)(1), 415(c)(6)(B). (Instead of borrowing directly or selling stock to others to finance business activities (in which case it would have to make principal or dividend payments with after-tax cash flow), the sponsoring employer sells stock to its ESOP, guarantees repayment of the ESOP's debt to a lender, and funds the ESOP's entire debt service with pre-tax contributions (in which case principal payments are made with pre-tax cash flow).

and continued in the Tax Reduction Act of 1975,[18] the Tax Reform Act of 1976,[19] the Economic Recovery Tax Act of 1981,[20] the Deficit Reduction Act of 1984,[21] and the

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The employees become stockholders, and the employer's cost of funds drops significantly.)

[18] Until superseded by the Economic Recovery Tax Act of 1981 ("ERTA"), a corporate employer was entitled to a 1% addition to its 10% investment tax credit for an equivalent contribution to its ESOP. (The government paid 100% of the ESOP contribution.) 26 U.S.C. § 46(a)(1)(B) (Supp. V 1975) (repealed 1981).

[19] Until superseded by ERTA, a corporate employer was allowed an *additional* 1/2% investment tax credit for a contribution matched by employees. 26 U.S.C. § 46(a)(2)(B)(ii) (1976) (repealed 1981). As a result of the Tax Reform Act of 1976 ("TRA 76"), ESOPs enjoy an exception to the general prohibition against any distribution of funds to an employee until retirement, disability or separation for employer dividends passed through to the participants. 26 C.F.R. § 54.4975-11(f)(3) (1979). Those dividends can, in turn, be used to finance the employee contributions. *See generally* TRA 76, § 803(h), 90 Stat. 1520, 1590.

[20] ERTA replaced the additions to the investment tax credit described *supra* notes 18 and 19 with a tax credit of up to 1/2% of total participant payroll. 26 U.S.C. § 41(a)(2) (Supp. IV 1981) (repealed 1986). (The government was still bearing the cost dollar-for-dollar, but the "base" was shifted from investment in capital equipment to the payroll of the employees who are participants in the ESOP.) While 1/2% is a small percentage, total payroll costs provide an extraordinarily large "base" for determining the amount of the government subsidy.

[21] The Deficit Reduction Act of 1984 ("DEFRA") augmented the provisions described *supra* note 19 by allowing a corporate income tax deduction for dividends paid to an ESOP that are passed through to participants. 26 U.S.C. § 404(k)(2)(A)-(B) (Supp. II 1984). (This eliminated the generally applicable "double tax" (once at the corporate level and once at the plan participant level) on a part of the corporation's earnings.)

TRA.[22] While most of these exotic provisions provide tax incentives to employers that fund ESOPs, Section 133

Moreover, DEFRA provides an income tax *exclusion* for banks of one-half of interest income (in an unlimited amount) from ESOP loans. Section 133.

DEFRA also permits persons who sell stock in a closely held company to its ESOP to defer tax on an unlimited amount of long-term capital gain by reinvesting the proceeds of sale in other securities. Section 1042. (This allows a taxpayer with substantial appreciation in closely held stock to diversify, defer gain recognition, and still have the potential of completely avoiding gain recognition if the replacement securities are held until death. Section 1014.)

Lastly, until repealed in 1989, DEFRA permitted an ESOP to assume the estate tax obligation attributable to stock in the sponsoring employer for a shareholder who sold the stock to the ESOP, provided the employer guaranteed the payment of tax. Section 2210 (repealed 1989). (This provision allowed the corporation to pay an unlimited amount of estate tax with pre-income tax dollars, rather than requiring the shareholder to pay the tax with the much smaller net proceeds of corporate income after it had been taxed first at the corporate level and then (as a dividend) at the shareholder level.)

[22] The TRA repealed the tax credit funding of ESOPs with a direct dollar-for-dollar tax subsidy, but added a corporate income tax deduction for dividends paid on stock held by an ESOP when those dividends are applied to the repayment of a loan used to acquire employer securities. Section 404(k)(2)(C) (now codified at 26 U.S.C. § 404(k)(2)(A)(ii) (Supp. I 1989)). (By eliminating the corporate-level tax on income used to finance ESOP stock purchases (as well as deferring the tax at the participant level), this provision further encourages a corporate employer to "leverage" its ESOP contribution by guaranteeing repayment of a loan to the ESOP while providing the funds to service the debt out of pre-tax corporate income.)

The TRA extended the unlimited 50% interest income exclusion of DEFRA described *supra* note 21 to regulated investment companies, as well as banks. Section 133(a)(4).

encourages banks and regulated investment companies to assist in the funding of ESOPs with interest rate discounts and Section 1042 encourages shareholders to assist with price discounts when selling employer securities to its ESOP (as did Section 2210 before its 1989 repeal). The tax law leaves to negotiations in the marketplace the allocation of the expected tax benefit between the "outsider" and the ESOP.[23]

Finally, the TRA enacted the new estate tax deduction that is the focus of this litigation.

[23] The Solicitor General's argument that the executor's loss on the sale is not relevant to the deduction, and that he could as easily have made a profit on the transaction (Br. for U.S. 4 n.6, 28), misses the point. Although gain or loss when compared with income tax basis is irrelevant, sale below market price is the *sine qua non* of the deduction; without a discount, an ESOP simply would buy stock in the open market, and the executor would get no deduction. A sale above income tax basis but below fair market value is just as much a bargain sale as one below income tax basis.

Like Section 2057, Section 2210 (repealed 1989) did not explicitly require a discount price when the ESOP assumed estate tax liability in connection with a purchase of stock from an executor; Section 1042 does not explicitly require a discount for a shareholder to defer gain on an ESOP sale; and, Section 133 does not require a discount interest rate for banks to exclude one-half of the interest income from an ESOP loan from income. Instead, Congress gave the ESOP bargaining power to obtain a portion of the tax benefit available to the seller or lender; an ESOP will participate in any particular tax-induced transaction *only* at a discount (because of the existence of other potential sellers or lenders and the ability to buy or borrow at market rates from others without any restriction on the ESOP after the purchase or borrowing). In each case the market determines the allocation of the tax benefit between the ESOP and the "third party." The Court of Appeals recognized this economic fact of

In this legislative context, the provisions of the new estate tax deduction were neither unusual nor surprising.

B. Nothing in Section 2057 or its Legislative History Presaged the Retroactive Restrictions.

Contrary to petitioner's implication (Br. for U.S. 24), Section 2057 was not a last-minute addition in Conference Committee. Language similar to that enacted as part of the TRA was proposed by the Senate in 1984 as part of the Deficit Reduction Act of 1984, S. Rep. No. 169, 98th Cong., 2d Sess., vol. I, at 335, vol. II, at 338-40, but was deleted in the Conference Committee deliberations in 1984, H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1181-84. In 1985, the deduction was included in a study of ESOP proposals. 1985 Joint Committee Study 20, 37.[24] In

life, *Carlton*, 972 F.2d at 1061, and, indeed, the government has stipulated that the executor would not have sold and the ESOP would not have been able to purchase the stock at a discount if the executor had not anticipated the Section 2057 deduction. (Br. in Opp. App. 51a.)

[24] The 1985 Joint Committee Study contains a relatively detailed review of then-existing law (with particular attention to incentives for ESOP financing), the Reagan Administration's May 1985 proposal for changes relating to ESOPs, other proposals that had been advanced, and an analysis of those various proposals. One proposal discussed briefly, *id.* at 20, 37, was the Senate Finance Committee's 1984 proposal for an estate tax "exclusion." As drafted in 1984, it would have allowed an estate tax deduction for one-half of the sales proceeds for sales completed by a stockholder during lifetime or by an executor at any time before the federal estate tax return was due (including extensions). The 1985 Joint Committee Study noted several objections to allowing a deduction for lifetime sales and certain

the spring of 1986, the Senate added Section 2057 to its version of the TRA. S. Rep. No. 313, 99th Cong., 2d Sess., pt. 1, at 681-82, pt. 2, at 2175-78. Except for adding a five-year "sunset" provision, the House acceded in the Conference Committee. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., pt. I at 453-54, pt. II at 560 (1986).

As enacted (and when the 99th Congress adjourned), the statute was clear on its face. Indeed, the government has stipulated that: (1) neither the decedent ownership nor the plan allocation requirement was contained in Section 2057 as initially enacted (Br. in Opp. App. 52a); (2) neither was contained in any amendment to the statute before the executor made his below-market sale to the ESOP, filed his estate tax return, and paid his tax (*id.*); (3) neither was contained in any of the hundreds of potential technical and clerical amendments to the statute considered before the Congress adjourned (*id.* at 48a-49a, 52a); and (4) "[n]o bill or resolution was introduced that would have added any condition to the availability of the new [s]ection 2057 deduction other than those contained in the statute itself during the period between the passage of

other objections to the 1984 Senate provision. Singularly absent from the discussion is any suggestion of an ownership requirement – either for a particular period of time (like the 12-month holding period then required for deferral of gain on a stockholder's sale to an ESOP under Section 1042(b)(4), 1985 Joint Committee Study at 14), or during a decedent's lifetime (as was required for an ESOP's assumption of estate tax liability under Section 2210(b)(2)(A) (repealed 1989)). Also absent is any discussion of a plan allocation rule like that now sought to be imposed retroactively.

the [1986 legislation] and the adjournment [of the 99th Congress] on October 18, 1986" (*id.* at 49a).[25]

Petitioner contends that the more obscure history of the 1986 legislation should have forewarned the executor that a deduction would not be available to him, because Mrs. Day had not owned the MCI stock before her death. (Br. for U.S. 5 n.7, 27 n.19.) As did the Court of Appeals, this Court should "flatly reject the government's premise that a taxpayer cannot rely on the clear and unequivocal text of the tax code, but instead must speculate on the unspoken and inchoate intentions of Congress." *Carlton*, 972 F.2d at 1060.[26] Assuming, *arguendo*, that the executor

[25] In view of the hundreds of proposed amendments to the TRA considered before the 99th Congress adjourned (one of which dealt specifically with Section 2057) and the TRA changes enacted by the Omnibus Budget Reconciliation Act of 1986, Pub. L. No. 99-509, 100 Stat. 1874 (Br. in Opp. App. 48a-49a), Congress did not act to amend Section 2057 "at the first opportunity," as petitioner contends (Br. for U.S. 24-25).

[26] Because the language of Section 2057 was clear, there was no more reason for the executor to consult the legislative history than there would be for a court to do so in interpreting the statute. *Cf. Toibb v. Radloff*, 111 S. Ct. 2197, 2200 (1991) ("although a court appropriately may refer to a statute's legislative history to resolve statutory ambiguity, there is no need to do so [when the language is not unclear]"; "even were we to consider the sundry legislative comments urged in support of a congressional intent . . . , the scant history on this precise issue does not suggest a 'clearly expressed legislative inten[t] . . . contrary' . . . to the plain language of [the statute]") (citing *Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980)).

could not rely on the plain language of the statute, however, there still was no reason to foresee the two retroactive conditions. Although the language of both the 1985 Joint Committee Study and Senator Long's prepared statement suggests that the deduction would be *available* to the executors of persons who held appreciated securities, there is nothing in either statement or elsewhere in the legislative history petitioner has identified that suggests the deduction would be *limited* to them.[27] By contrast, Congress has explicitly included ownership and holding period requirements in other ESOP tax subsidy provisions where it intended them to apply.[28] Similarly,

[27] *See* 1985 Joint Committee Study at 37; 132 Cong. Rec. at 14507. If limited, would the class be limited to incorporators, shareholders who had purchased stock other than on the open market, shareholders of corporations that do not have publicly traded stock, or just the estates of persons who had been shareholders at the instant of death? Even if this Court were to conclude that the deduction was *intended* for the executors of shareholders who had held their stock during a period when the company grew, it should not interpret the statute as applying *only* in that context. *See, e.g., Barr v. United States*, 324 U.S. 83, 90 (1945) ("if Congress has made a choice of language which fairly brings a given situation within a statute, it is unimportant that the particular application may not have been contemplated by the legislators").

[28] Congress has included both ownership history and plan allocation requirements in some ESOP tax subsidy provisions and not in others. For example, Section 2210 (repealed 1989) (which provided for an ESOP's assumption of an estate tax liability in connection with the sale of stock by an executor to an ESOP) specifically required ownership by a decedent – but not for any particular period of time. Section 1042 (allowing a taxpayer to defer gain recognition on the sale of closely held stock to an ESOP) required a simple one-year holding period, 26

petitioner has identified nothing, whatsoever, that presaged the plan allocation rules that the Congress also seeks to impose retroactively. Not even the clairvoyance presumed by the Solicitor General in arguing the predictability of the ownership limitation could have foretold the plan allocation requirement; this change effectively repealed the deduction for any executor who acted before January 5, 1987.

Finally, petitioner implicitly contends that the executor should have anticipated the 1987 restrictions because of the factors *later* discussed during the legislative consideration of the 1987 amendments. (Br. for U.S. 4-5, 17-18, 26.) By repeating the 1987 floor statements of then-Senator Bentsen and Representative Rostenkowski,[29] petitioner implies that the purportedly unintended revenue

U.S.C. 1042(c)(1)(B) (Supp. II 1984) (repealed 1986), which the TRA changed to a requirement that the stock be long-term capital gain property (including property held for more than six months if acquired before the end of 1986 or one year thereafter and excluding property that otherwise would be treated as ordinary income property), *see* Staff of Joint Committee on Taxation, 100th Cong., 1st Sess., *Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation* 152 (Comm. Print 1987). Section 133 (which provides for the interest exclusion for banks and mutual funds) does not restrict the use of proceeds to purchase stock based on any criterion of a selling shareholder's ownership history. Congress knew how to limit an ESOP tax subsidy with ownership history conditions when it intended to do so; it did not do so in Section 2057.

[29] This Court should exercise its traditional skepticism about the weight to be accorded the views of members of a later Congress about the intent of a former one. *See, e.g., United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 34 (1982) (citing *International Bhd. of Teamsters v. United States*, 431 U.S. 324, 354 n.39 (1977)), particularly because this "intent" was not announced until a

loss, which "became clear soon after the passage of the 1986 Act" (Br. for U.S. 5), should have been anticipated by the executor when he sold his MCI stock at a discount in early December 1986 and should have forewarned him of change. This position requires prescience on the part of the executor that the government itself lacked; it was not until January 5, 1987 that the Service released the advance version of Notice 87-13 and until February 26, 1987 that the chairmen of the Congressional tax-writing committees introduced legislation to restrict the availability of the Section 2057 deduction. Petitioner has identified no basis for the premise that the executor could have known of a 1986 revenue loss estimate. Moreover, as noted by the Court of Appeals, even the revised revenue loss estimate described by the legislators in February 1987 would have seemed plausible in the general context of spending for ESOPs and other qualified plans. *Carlton*, 972 F.2d at 1060.[30]

few days after the retirement of Senator Russell B. Long, who spearheaded the enactment of Section 2057 as part of the TRA and who, generally, championed the cause of ESOPs during his tenure as chairman (or ranking minority member) of the Senate Finance Committee from 1965 through 1986.

[30] Petitioner argues that Congress initially anticipated that the new deduction would cost about $300 million (over fiscal years 1987-1991) and then revised that estimate shortly after the statute was enacted to $7 billion (over the same period). (Br. for U.S. 4-5, 17, 26.) Although those cost estimates were contained in the statements made by Representative Rostenkowski, 133 Cong. Rec. 4145 (1987), and Senator Bentsen, 133 Cong. Rec. 4294 (1987), when the 1987 "clarifying" legislation was introduced on February 26, 1987, there is no evidence that the executor knew, should have known, or even could have known of the two estimates when he sold his MCI stock to its ESOP.

In summary, the Court of Appeals was correct when it concluded that the 1987 changes were not foreseeable:

> It is undisputed that Carlton had no actual notice of the 1987 amendment imposing the decedent ownership requirement when he completed the MCI ESOP transaction in 1986. Nor is there any basis upon which Carlton could have had constructive notice of the future imposition of the decedent ownership requirement.

972 F.2d at 1059.

Even if the revised cost estimate had been known in the fall of 1986, there is no reason to believe that a reasonable executor would have concluded that an ownership requirement and plan allocation requirement had been omitted inadvertently from the statute. In December 1986, the General Accounting Office reported that over the seven-year period from 1977 through 1983, tax incentives for ESOPs cost between $12.1 billion and $13.3 billion compared with total ESOP assets of about $19 billion in 1983. *Employee Stock Ownership Plans: Benefits and Costs of ESOP Tax Incentives for Broadening Stock Ownership* (GAO/PEMD 87-88) 1 (1986). Similarly, the 1985 Joint Committee Study reports that: "the tax expenditure for [all] qualified plans [including ESOPs] is the largest single item of tax expenditures. For fiscal year 1986, the tax expenditure for employer-maintained qualified plans (including Keogh plans) is estimated to be $56.8 billion, and this expenditure is projected to increase to $88.9 billion for fiscal year 1990. For fiscal years 1986 through 1990, the total expenditure is estimated to be $359.8 billion." 1985 Joint Committee Study at 21 n.29.

III. THE GOVERNMENT'S SUPPORT FOR THE RESULT IT SEEKS IN THIS CASE DOES NOT WITHSTAND CAREFUL ANALYSIS.

A. The Circumstances of this Case Readily Distinguish it from those in which the Court Has Upheld Retroactive Taxation.

The government's inducement of a below-market sale that no taxpayer otherwise would have made and the absence of actual or constructive notice that would have made the 1987 changes foreseeable distinguish this case. None of the cases cited by petitioner involves similar circumstances.

1. Legislation Pending and Ratification Cases.

Statutory change was easily foreseeable in a number of the cases cited by the Solicitor General that involve action while a legislative proposal was under consideration or after one had been under consideration in an adjourned legislative session. For example, in *Cooper v. United States*, 280 U.S. 409 (1930), the Finance Committee had described the kind of transaction engaged in by the Coopers as a specific abuse of the income tax law to be eliminated by proposed legislation *several weeks before* their gift and sale.[31] Similarly, in *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717 (1984), the Court concluded that retroactive application during legislative consideration "prevented employers from taking advantage of a lengthy legislative process and withdrawing

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[31] S. Rep. No. 375, 67th Cong., 1st Sess. 10 (Sept. 26, 1921).

[from multi-employer pension plans] while Congress debated necessary revisions in the statute," 467 U.S. at 731.[32] Finally, in *United States v. Hemme*, 476 U.S. 558 (1986), the separate exemptions for the estate and gift taxes had been replaced with the unified credit that is applied to both, and the Court upheld a transition rule intended to prevent taxpayers from exploiting the planned change between the date the Conference Committee approved the bill and its effective date.[33]

Change also was foreseeable in a group of cases cited by the Solicitor General involving instances where the Executive had sent a message to Congress calling for the legislation.[34] *Ferman v. United States*, 993 F.2d 485 (5th Cir.

[32] *Accord Concrete Pipe & Prods. of California, Inc. v. Construction Laborers Pension Trust*, 113 S. Ct. 2264 (1993).

[33] Mr. Hirschi made his gifts three weeks *after* the Conference Committee action and less than one week before the President signed the bill. *Hemme*, 476 U.S. at 562-63. The Solicitor General also cites three other estate tax cases arising out of the unification of the estate and gift tax systems in the late 1970s in which the taxpayer acted during legislative consideration. *Estate of Ekins v. Commissioner*, 797 F.2d 481 (7th Cir. 1986); *Reed v. United States*, 743 F.2d 481 (7th Cir. 1984), *cert. denied*, 471 U.S. 1135 (1985); and *Estate of Ceppi v. Commissioner*, 698 F.2d 17 (1st Cir.), *cert. denied*, 462 U.S. 1120 (1983).

[34] These include *United States v. Hudson*, 299 U.S. 498 (1937) (legislation to stem silver speculation in anticipation of Depression-era government purchases); *Purvis v. United States*, 501 F.2d 311 (9th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975), and *First Nat'l Bank in Dallas v. United States*, 420 F.2d 725 (Ct. Cl.), *cert. denied*, 398 U.S. 950 (1970) (each involving the 1963 interest equalization tax to reduce foreign investment); and, *Sidney v. Commissioner*, 273 F.2d 928 (2d Cir. 1960) (change in the collapsible corporation rules by categorizing a distribution as ordinary

1993), *petition for cert. filed*, 62 U.S.L.W. 3299 (U.S. Oct. 12, 1993) (No. 93-569)), deals with the effect of the Notice (which suggested the two additional conditions on the Section 2057 deduction): Does a sale after the Notice but before the introduction of the 1987 legislation fall within this line of cases? The Fifth Circuit effectively concluded that it does. 993 F.2d at 491. *See also Carlton*, 972 F.2d at 1062 (dictum).

Finally, change was particularly foreseeable in cases cited by the Solicitor General in which Congress ratified a prior regulatory or administrative practice. For example, *Graham & Foster v. Goodcell*, 282 U.S. 409 (1931), involved a group of tax refund suits concerning the collection of income and World War I excess profits tax after the expiration of the statute of limitations. The government had erroneously believed that the statute was tolled by consideration of abatement claims. After the Court decided otherwise, a number of taxpayers filed refund claims. Congress provided that no refund was due, and the taxpayers then challenged the application of that provision to their refund actions on Due Process grounds. Retroactive application avoided a windfall to the taxpayers and produced the expected result. Reliance by the

income rather than capital gain to the shareholder). See also *Brushaber v. Union Pac. R.R.*, 240 U.S. 1 (1916), a broad challenge to the income tax enacted shortly after the Sixteenth Amendment that included a challenge to its application for the period between its March 1 effective date and enactment on October 3. Because the amendment, itself, had been ratified on February 3, 1913, the adoption of a federal income tax could hardly have been more foreseeable.

taxpayer was not an issue, and the government certainly did not induce the taxpayer's underlying behavior.[35]

2. Tax Administration and Rate Cases.

The Court consistently has upheld Congress's power to change the specific ways in which existing tax laws are administered with respect to taxable events and rates of tax and to apply those changes to periods for which returns have not yet been filed. In this vein, petitioner argues that a taxpayer ought to expect changes in the tax laws (Br. for U.S. 20), quoting the opinion of Judge Learned Hand in *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930). That case involved entertainer George M. Cohan, who shifted his fiscal year for income tax purposes in January of 1921. Later that year, the statute providing for the treatment of "short" years was amended to require "annualization" of income. Cohan complained that he had received several payments during his short year that were not representative of an

[35] Other cases include *New England Baptist Hosp. v. United States*, 807 F.2d 280 (1st Cir. 1986), *Canisius College v. United States*, 799 F.2d 18 (2d Cir. 1986), *cert. denied*, 481 U.S. 1014 (1987), and *Temple Univ. v. United States*, 769 F.2d 126 (3d Cir. 1985), *cert. denied*, 476 U.S. 1182 (1986). All arose out of Congress's ratification of an IRS ruling position that the taxpayers had followed at the time they had filed their returns. The factual contrast with the present controversy is striking: The employees had made retirement annuity contributions and the employers had paid FICA taxes assuming that the retirement annuity contributions would constitute wages for FICA purposes; as the law evolved, the expectations were satisfied. See also *United States v. Heinszen & Co.*, 206 U.S. 370 (1907) (ratification of Executive Order for collection of tariffs in Philippines).

entire 12-month period. Judge Hand rejected Cohan's complaint, contrasting it with another:

> His is a different case from that of one who, when he takes such action, has no reason to suppose that any transactions of the sort will be taxed at all.

39 F.2d at 545. Here, the executor would not have made the below-market sale to the ESOP but for the estate tax deduction; application of the retroactive changes would be even more egregious than in Judge Hand's contrasting situation in *Cohan*.[36]

Another example of this sort of "routine" change is *Milliken v. United States*, 283 U.S. 15 (1931), in which the

[36] *Sidney v. Commissioner*, 273 F.2d 928 (2d Cir. 1960), involved a change in the collapsible corporation rules by categorizing a distribution as ordinary income rather than capital gain to the shareholder. Judge Friendly observed: "The distribution in the instant case was of a sort long subject to Federal income taxation; § 117(m) changed the law only as to the category of income and consequently the rate." 273 F.2d at 932. (Moreover, the distributions involved were made *after* President Truman's message proposing the change. 273 F.2d at 932.) From a more recent era, *United States v. Darusmont*, 449 U.S. 292 (1981) (per curiam), *Westwick v. Commissioner*, 636 F.2d 291 (10th Cir. 1980), *and Buttke v. Commissioner*, 625 F.2d 202 (8th Cir. 1980), are similar. All arose out of a 1976 change in the computation of the minimum tax. (In each, the sale also was made while the proposed legislation was under consideration, and in none was there any showing of detrimental reliance by the taxpayer. In *Darusmont*, for example, the taxpayer was not even aware of the minimum tax when deciding how to structure the sale. 449 U.S. at 295.) The most recent of this line of cases is *Wiggins v. Commissioner*, 904 F.2d 311 (5th Cir. 1990) (1984 change to the computation of alternative minimum tax for 1983).

Court upheld an increase in the estate tax rate between the time when an includable gift was made and the donor's death.

> Decedent's gift as a substitute for a testamentary disposition was . . . brought within the operation of the 1916 Act taxing such gifts on the same basis, with respect to rate and valuation as transfers of property at death. Not only was the decedent left in no uncertainty that the gift he was then making was subject to the provisions of the existing statute, but in view of its well-understood purpose, he should be regarded as taking his chances of any increase in the tax burden which might result from carrying out the established policy of taxation under which substitutes for testamentary gifts were classed and taxed with them.

283 U.S. at 23.

Several of the cases cited by the Solicitor General involve the income taxation of multi-year transactions where changes in the law in future years are inherently foreseeable. *Shanahan v. United States*, 447 F.2d 1082 (10th Cir. 1971), *Lawler v. Commissioner*, 78 F.2d 567 (9th Cir. 1935), and *Rose v. Commissioner*, 55 T.C. 28 (1970), all concern installment sales in which the taxpayer knew that part of the gain would be taxed in future years. (Indeed, the sales in *Shanahan* and *Rose* were made while the legislation was under consideration.) *Miller v. Commissioner*, 115 F.2d 479 (9th Cir. 1940), *cert. denied*, 312 U.S. 703 (1941), concerns the treatment of a loss carryforward, and *Estate of Papson v. Commissioner*, 81 T.C. 105 (1983), concerns merely a change in the interest rate for deferred estate tax payments.

Although changes in tax administration and rates of the type involved in this line of cases were foreseeable, inducing a below-market sale and, then, reneging on the tax benefit was not.

3. Absence of Reliance Cases.

Regardless whether change clearly was foreseeable or whether a change was simply in the administration of existing tax laws, the record in some cases is devoid of any evidence of reliance on the existing state of the law by the taxpayer.

In *Welch v. Henry*, 305 U.S. 134 (1938), for example, Wisconsin's 1933 income tax statute had allowed a deduction for dividends received from corporations whose principal business was attributable to Wisconsin. Because most of Welch's gross income for that year consisted of such dividends, his return filed in the spring of 1934 showed no taxable income for 1933. At the next legislative session (in 1935), Wisconsin modified its income tax law to impose new taxes for 1933 and 1934 to raise money for unemployment relief which effectively rescinded the deduction for "Wisconsin dividends" for 1933. The Court rejected both Equal Protection and Due Process challenges to the Wisconsin action. Insofar as the latter is concerned, Justice Stone noted the long federal history of amending the income tax law to apply to the year of enactment "and in some instances during the year of the preceding session," 305 U.S. at 148, and concluded that the 1935 Wisconsin tax on dividends of in-state companies received "during the year of the legislative session preceding that of its enactment" did not violate Due Process. 305 U.S. at 150-51. Although the 1933 deduction

may have encouraged Welch to invest in his home state, there is no suggestion in the record that Welch would not have invested in the Wisconsin stock but for the provisions of the 1933 legislation. Indeed, Justice Stone observed:

> We can not assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax or to the increase of an old one.

305 U.S. at 148.

In *General Motors Corp. v. Romein*, 112 S. Ct. 1105 (1992), the absence of reasonable reliance on the existing state of the law was even clearer. The employer repeatedly paid reduced workers compensation benefits in the face of substantial controversy about the effective date of a statutory change allowing "benefit coordination." "Refund" legislation did not offend Due Process.[37]

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[37] In *Stockdale v. Insurance Cos.*, 87 U.S. (20 Wall.) 323 (1874), a divided court upheld the validity of an income tax collected from corporations on dividends attributable to income earned between July 1869 and June 1870; the tax had been in force since 1863, and the question was when it expired; the taxpayer made no detrimental reliance argument, and the Court considered no Due Process argument. In *Fein v. United States*, 730 F.2d 1211 (8th Cir.), *cert. denied* 469 U.S. 858 (1984), the taxpayer made a premortem life insurance transfer of a kind traditionally causing inclusion of the proceeds in a decedent's gross estate for estate tax purposes. Moreover, the insurance would have been subject to tax if not transferred, so that retroactive application of the statutory change did not make the situation of the taxpayers any worse than if they had not transferred the insurance. Finally, the Court of Appeals specifically noted the absence of any showing of reliance by the taxpayer. 730 F.2d at 1213.

Other cases cited by petitioner involve activities affirmatively discouraged by social policy, not encouraged, and in which the taxpayer certainly could not have relied reasonably on the existing language of the statutes;[38] in contrast, inducing below-market sales to ESOPs was the purpose of Section 2057.

4. Cost Allocation Cases.

Finally, the Solicitor General cites two cases in which some citizens received the benefit of a particular government program that others did not.[39] In *Usery v. Turner*

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[38] For example, *Long v. IRS*, 742 F.2d 1173 (9th Cir. 1984), involved a FOIA attempt to obtain information about the taxpayer compliance measurement program. Retroactive application was appropriate to prevent subversion of the administration of the tax laws. Similarly, *DeMartino v. Commissioner*, 862 F.2d 400 (2d Cir. 1988), arose out of a sham transaction that did not even rise to the technical definition of a tax-motivated straddle. Retroactive application of an unusually high interest rate on the resulting tax deficiency (as if the transaction had been a tax-motivated straddle) was justified.

[39] *Gray*, discussed *supra* text accompanying note 32, also involves a cost allocation issue. Before the 1980 amendments, employers withdrawing from multi-employer pension plans potentially were liable if the plan terminated within five years and lacked sufficient funds to pay benefits, 467 U.S. at 720-21; after the amendments, employers withdrawing from underfunded plans were liable immediately for their pro rata share of the shortfall, *id.* at 723. In each case, withdrawing employers were being charged with the cost of underfunding benefits for those in a pool of workers that included their employees, and the 1980 amendments merely changed the way in which employers withdrawing from multi-employer plans would bear a share of the underfunding from which they, presumably, had received the benefit of lower labor costs.

Elkhorn Mining Co., 428 U.S. 1 (1976), the Court found that imposition of the costs of black lung disease benefits on the operators and coal consumers, who (generically) had received the benefit of the workers' labor, was a rational way for Congress to allocate those costs. 428 U.S. at 18. Similarly, in *United States v. Sperry Corp.*, 493 U.S. 52 (1989), the Court determined that allocation of the costs of the United States' Claims Tribunal through a user fee applying to all who had received the benefit of the Tribunal (and not just those whose awards became effective after the date of enactment) was a rational way of allocating the costs of the Tribunal.[40]

The facts of the cases cited by the Solicitor General stand in stark contrast to those here. Neither Mrs. Day nor her executor enjoyed (1) the economic benefit of prior conduct that gave rise to a particular cost, as was the case in *Turner Elkhorn*, or (2) the peculiar benefit of a current government program available only to the few, as was the case in *Sperry*. Mrs. Day's executor acted before any legislative or executive branch activity suggesting a likely change. Unlike the periodic changes in the administration of the tax law and rate changes the Court has approved in the past, Congress here seeks to deprive the executor of *both* his share of the expected tax savings *and* the share that he irrevocably transferred to the ESOP. *Unlike the taxpayers in all of the cases cited by petitioner*, Mrs. Day's

[40] The Iranian government did not approve the *Sperry* settlement until July 1982, and the Treasury issued its directive for the "user fee" in June 1982, 493 U.S. at 56-57, arguably making *Sperry* a member of the "legislation pending and ratification" category of cases discussed *supra* notes 31-35 and accompanying text.

executor was specifically induced to make the below-market sale by Section 2057 when otherwise there would have been no reason, whatsoever, for him to do so. Application of the *post hoc* amendments *in this case* would be particularly "harsh and oppressive."

B. The Solicitor General Offers No Support for Retroactive Application in the Circumstances of this Case.

Just as the cases cited by the Solicitor General fail to provide a basis for retroactive taxation here, his arguments to support the retroactive narrowing of the ESOP subsidy with the decedent ownership and plan allocation requirements do not withstand careful analysis. The retroactive amendments did not prevent "sham" transactions, they did not establish a uniform rule for all estates to which the deduction was available, and they were not a rational means of raising revenue for the fisc. Describing changes as "curative" is of no help analytically, and retroactive application here would represent a triumph of Congressional myopia.

1. The Sham Transaction Theory.

Retroactive application of the changes to Section 2057 was not a rational means to prevent revenue loss as a result of "sham" transactions in pursuit of the goal of preventing evasion of the tax law "by the vigilant and ingenious" (Br. for the U.S. 15), because this transaction was one of economic substance and not one disguised in

form to obtain favorable tax treatment.[41] The executor's below-market sale was exactly what it purported to be; it accomplished a transfer of wealth from the beneficiaries of Mrs. Day's estate to the ESOP participants. The form and economics of this transaction for Mrs. Day's estate are the same as (and no more a sham than) they would have been had (1) Mrs. Day owned the stock before her death and (2) the plan agreed to allocate the stock in the fashion required by the 1987 amendments. Moreover, Mrs. Day's executor bore the economic risk of potential changes in the market value of the stock, just as if Mrs. Day had owned the MCI stock before her death.[42]

Although the government and the taxpayer have stipulated, in effect, to his vigilance (Br. in Opp. App. 50a), the executor can hardly be called "ingenious" in

[41] *Cf., e.g., Knetsch v. United States*, 364 U.S. 361 (1960) (leveraged single-premium deferred annuity "investment" in which borrowings kept cash value nominal and precluded accrual of any material annuity benefit); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945) (liquidating dividend followed by shareholder sale to buyer who had negotiated the terms of purchase from the corporation recharacterized as a direct sale by the corporation); *Gregory v. Helvering*, 293 U.S. 465 (1935) (in-kind distribution of appreciated securities through a corporate reorganization where sole shareholder formed new company solely to participate in the transaction and then immediately liquidated it recharacterized as a dividend).

[42] Although the executor held this stock for only a relatively short time, the holding period also would have been short if Mrs. Day had bought the stock on her deathbed and her executor had sold it immediately after her death. The critical issue is not the length of time the executor bore market risk, but that he did.

view of the plain language of Section 2057. As the Court of Appeals commented:

> The federal government has long sought to promote employee ownership of shares in their employers. Section 2057 was enacted to induce taxpayers to sell shares at a discounted price to an ESOP, thus furthering the public policy of employee ownership. As intended, the Day estate succumbed to the lure and sold shares to the MCI ESOP at a substantial discount. Section 2057 worked. An ESOP was able to buy more shares at a lower price than before. Then, when the private actor had completed the socially desirable action of selling shares at a discount to an ESOP, the government reneged on its end of the deal. It was too late for Carlton to undo his sale to the MCI ESOP. The $631,000 was gone forever, irretrievable.

Carlton, 972 F. 2d at 1060.

Whenever the tax law is used to promote social goals, Congress intends to affect taxpayer behavior. Surely, the Solicitor General cannot be correct when he suggests that taxpayers lose the protection of Due Process simply because behavior can be labeled "tax motivated" or "tax avoidance." (Br. for U.S. 11, 17 & n.13, 26, 27 n.19.)[43] The

[43] Although the Solicitor General derides "tax motivated" transactions, Judge Learned Hand succinctly observed that: "a transaction, otherwise within an exception of the tax law, does not lose its immunity, *[sic]* because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.

transaction here is no more suspect than a bank's stock acquisition loan to an ESOP at a below-market interest rate that is motivated by the bank's desire to exclude one-half of the interest from its taxable income.[44] Just as it would violate Due Process to add conditions retroactively to Section 133, making the exclusion inapplicable to interest income received by a bank from loans already made, it also violates Due Process to apply the two conditions suggested by the Notice retroactively.

2. The Uniform Application Theory.

Petitioner suggests that retroactive application of the decedent ownership and plan allocation requirements to this transaction would provide "a uniform rule for all estates to which the deduction is available." (Br. for U.S. 19.) To the contrary, the 1987 amendments to Section 2057 neither provide a uniform rule for the application of the ESOP proceeds deduction nor represent a rational means to achieve uniformity. The "curative" legislation narrowed the scope of Section 2057 by imposing ten restrictions on the deduction not contained in the initial statute. Two, the decedent ownership requirement and the plan allocation requirement, are to operate as if included from the outset, Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203 § 10411, 101 Stat. 1330, 1330-432 to

Therefore, if what was done here was what was intended by [the section involved], it is of no consequence that it was all an elaborate scheme to get rid of income taxes, as it certainly was." *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd sub nom. Gregory v. Helvering*, 293 U.S. 465 (1935).

[44] See *supra* note 23 and accompanying text.

1330-433, and the remaining eight[45] are to be effective only for sales after February 26, 1987, the date the 1987 legislation was introduced, *id.*, § 10412(b), 101 Stat. at 1330-435 to 1330-436. The 100th Congress provided two rules, not one. Moreover, executors considering ESOP sales after February 26th had the opportunity to know of and base their conduct on the proposal that 100th Congress ultimately used to narrow dramatically the scope of the deduction. Executors considering ESOP sales after January 5th had a reason to foresee the possible addition of the decedent ownership and plan allocation requirements. Executors acting before January 5th, however, had no basis to foresee the possible changes. Applying the same restrictions to them as to those who acted between January 5 and February 26 is singularly arbitrary, because

[45] These were (1) a limit on the maximum deduction (the lesser of that deduction that would result in a $750,000 tax savings or a deduction equal to one-half of the taxable estate without the deduction), (2) a reduction of the sales proceeds that could qualify in the event the ESOP had purchased or sold employer securities in the prior year, (3) a disqualification of proceeds attributable to assets transferred to an ESOP from other forms of tax-exempt retirement plans (unless the Service determined otherwise), (4) a requirement that proceeds be received before the estate tax return was due, (5) a disqualification of stock a decedent acquired as compensation (whether tax-deferred or not) from the employer, (6) a limit to securities of an issuer that does not have any stock that is readily tradable on an established securities market, (7) a holding period requirement dating back to October 22, 1986 for the decedent or his or her spouse, and (8) a provision that disqualified stock if the decedent had engaged in certain kinds of hedging transactions to reduce the risk of loss if the stock declined in value. Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10412(a), 101 Stat. 1330, 1330-433 to 1330-435.

it would deprive them of the benefit that induced their below-market sales without warning.[46]

The Solicitor General's uniform allocation theory proves too much: It would eviscerate the Due Process limit on retroactive taxation, because Congress could justify the *post hoc* application of *any* change on this ground. Without considering whether the means employed to achieve an objective results in an unduly "harsh and oppressive" effect on the taxpayer, this theory would eliminate any distinction between Congressional exercise of the Taxing Power prospectively and retroactively. It ignores the particular burden carried by retroactive legislation.[47]

3. The Revenue Raising Theory.

Although petitioner does not explicitly argue that the Taxing Power is entirely unconstrained by the Due Process Clause, he implicitly adopts that position in a third rationale for retroactive application of the 1987 changes in Section 2057, "to distribute increased costs of government among its taxpayers in light of present need for revenue." (Br. for U.S. 19 n.16.) To permit retroactive taxation solely because it increases tax revenue, without

[46] The only discernable distinction between the two restictions that were to apply to all ESOP sales and the additional eight to be applied prospectively was that the decedent ownership and plan allocation rules were presaged by the Notice. There was no difference, however, in the foreseeability of any of the ten before release of the advance version of the Notice on January 5, 1987.

[47] See *supra* note 5 and accompanying text.

further inquiry, would eliminate any Due Process constraint, just as would the uniform application theory. The government always could justify a retroactive tax on the ground that it needs to increase revenue.[48]

4. The Closing a Loophole Theory.

To describe a change as "closing a loophole" or "curing a drafting error" simply announces a conclusion that retroactive application is permissible; it does not explain why. Notwithstanding post-transaction rhetoric, there is nothing in the legislative history to the 1986 statute that was available at the time the executor engaged in the transaction to disclose the two additional conditions for the deduction.[49] The Notice itself is persuasive evidence of the absence of any reason for the taxpayer to have anticipated the changes before January 5, 1987; if the intent had existed and been manifest in the legislative history of the TRA, there would have been no need for

[48] There is nothing in the record to suggest that prospective application of the two additional requirements from either February 26, 1987 (when the legislation was introduced) or January 5, 1987 (when the advance version of the Notice was released) would not produce roughly the same revenue result as retroactive application, notwithstanding the Solicitor General's implication to the contrary. (Br. for U.S. 4-5, 17, 26.)

[49] Moreover, the taxpayer respectfully suggests that even if one or more members of Congress did (secretly) intend to include the additional requirements to qualify for the deduction, that undisclosed intent is irrelevant. The executor's conduct could not have been guided by the undisclosed or unarticulated intent of one or more members of Congress or its staff.

the Notice or the self-serving declarations of the Congressional tax leaders in the early part of 1987. While Congressional "intent" may be relevant if a statute is at odds with specific discussion of its expected application during the legislative process (as in the case that would arise if the term "not" were added or omitted), the absence of any discussion of decedent ownership and plan allocation limits should be dispositive.

5. Congressional Myopia.

Application of the 1987 restrictions to the Day estate transaction would represent a triumph of Congressional myopia: Adopting petitioner's view that Due Process permits retroactive application in this case will discourage taxpayers from behaving in the future as the government wants them to behave.[50] The additional uncertainty that

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[50] Absent a definite, overt indication in the legislative history that the plain language of a statute is incorrect, how is a taxpayer to distinguish between a policy choice and a drafting error? How long should a prudent banker wait for possible legislative change before making a share acquisition loan to an ESOP at a below-market interest rate and thereby sharing with the ESOP participants and the corporate sponsor the benefit of the bank's ability to exclude one-half of the interest from taxable income under 26 U.S.C. § 133 (Supp. IV 1992)? What about a shareholder willing to sell stock at a discount from fair market value because of the tax deferral available under 26 U.S.C. § 1042 (Supp. IV 1992) or an executor who was willing to sell stock to an ESOP at a below-market price in a transaction in which the ESOP assumed (and the company guaranteed) the obligation to pay estate tax under Section 2210 (before its 1989 repeal)?

an apparently clear tax statute may be changed retroactively to impose an unexpected loss will cause those in the future to be reluctant to engage in "unproven" transactions and, consequently, reduce the amount of the tax benefit shared with the intended beneficiaries of tax policy. As Justice Cardozo said, "[l]aw as a guide to conduct is reduced to the level of mere futility if it is unknown and unknowable." Benjamin N. Cardozo, *The Growth of the Law* 3 (1924).

CONCLUSION

Application of the retroactive changes to Section 2057 in this case transgresses the Due Process limit, because it would be "harsh and oppressive." The changes were not foreseeable, the taxpayer would have acted differently had he foreseen them, he sustained actual injury, and his dedication of estate resources to pursue the public goal of ESOP funding was specifically induced by Section 2057. The facts here stand in stark contrast to the cases cited by petitioner in which retroactive legislation has been sustained. Similarly, petitioner has not advanced anything in the "nature of the tax and the circumstances in which it is laid" that justifies imposing the particularly "harsh and oppressive" result of retroactive application in this case. The decision of the Court of Appeals should be affirmed.

Respectfully submitted,

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December 1993